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# GATEKEEPER LIABILITY IN GOVERNMENT INVESTIGATIONS & PRIVATE LITIGATION

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**GIBSON DUNN**

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# Agenda

**1. Introductions and Overview**

**2. Gatekeeper Liability in Regulatory Enforcement**

**3. Gatekeeper Liability in Private Litigation**

**4. Takeaways and Q&A**

# INTRODUCTIONS AND OVERVIEW

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# Speakers



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# Overview

- **Gatekeepers play a crucial role in a company's legal compliance and corporate governance.**
- **Regulatory obligations on gatekeepers are increasing.**
- **Federal regulators are increasingly focused on gatekeeper failures in enforcement investigations and actions.**
- **Gatekeepers can also be subject to liability in private litigation, including shareholder actions.**

# Overview

## Who Are Gatekeepers?

### Who Are Gatekeepers?

Board and External Gatekeepers

Management Gatekeepers

Board of Directors

**Finance & Accounting**

**Technology**

**Legal / Compliance**

**Senior Management**

Audit Committee

Controller / Chief Accounting Officer

Chief Technology Officer

General Counsel

Chief Executive Officer

External Auditor

Internal Audit

Chief Information Security Officer

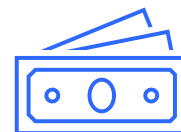
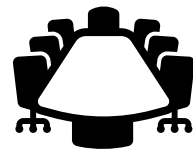
Chief Compliance Officer

Chief Financial Officer

Outside Counsel

Tax

Other Executives



# Overview

## *What Distinguishes Gatekeeper Liability?*

**Regulators often characterize “gatekeeper” cases where the claims revolve around affirmative misconduct, e.g., insider trading by parties who are in gatekeeper roles.**

**The cases where a party has actually fallen down in performing the actual gatekeeper function often involve unique facts.**



# Overview

## *Gatekeepers' Responsibilities*

### **Obligations for Gatekeepers Include:**

- **Issuance of Accurate Disclosures and Financial Statements**
  - Sarbanes-Oxley Act Sections 302, 906
- **Potential Reporting of Illegal Acts and Securities Violations**
  - Exchange Act Section 10A
  - Sarbanes-Oxley Section 307, 17 CFR Part 205
- **Maintenance of Effective Disclosure and Accounting Controls**
  - Exchange Act Section 13(b)(2)
  - SEC Rule 13a-15
- **Cybersecurity Reporting**
  - Form 8-K Item 1.05, Regulation S-K Item 106

# **GATEKEEPER LIABILITY IN REGULATORY ENFORCEMENT**

**02**

# Gatekeeper Liability in Regulatory Enforcement

## *A Focus on Gatekeepers*

“When lawyers—or other gatekeepers, like auditors and underwriters—breach their positions of trust and violate the securities laws, we will not hesitate to take action.”

**Gary Gensler**, SEC Chairperson, November 2022

“A recurring theme in many of the cases that I review each week is the failure of some of these important players or gatekeepers to disrupt or prevent misconduct.”

**Kara Stein**, SEC Commissioner, May 2014

Recent cryptocurrency failures are “a failure of an industry that has not empowered gatekeepers. In some cases, it is a failure of the gatekeepers themselves.”

**Christy Goldsmith Romero**, CFTC Commissioner, January 2023

“Gatekeepers, such as accountants, auditors, and other professionals who share responsibility for protecting investors, play critical roles in the capital markets as the first lines of defense against misconduct. Ensuring that they comply with their obligations is a critical part of the Division’s mission.”

**SEC Press Release**, SEC Announces Enforcement Results for Fiscal Year 2023, November 2023

“[A]ccountants and other gatekeepers are absolutely fundamental to the integrity of our capital markets” and “our ability to enforce rules and professional standards against those gatekeepers is a critical feature of that system.”

**Ryan Wolfe**, SEC Chief Enforcement Accountant, April 2024

# Gatekeeper Liability in Regulatory Enforcement

## *Limits to Gatekeeper Enforcement*

### **Then-SEC Enforcement Director Gurbir Grewal, Remarks to New York City Bar Association Compliance Institute, Oct. 24 2023:**

- “[W]hen does the Enforcement Division recommend charges against a compliance officer? The short answer is that we do not second-guess good faith judgments of compliance personnel made after reasonable inquiry and analysis. That is why such actions are rare. There are really three situations where the Commission typically brings enforcement actions against compliance personnel:
  - where compliance personnel affirmatively participated in misconduct unrelated to the compliance function;
  - where they misled regulators; and
  - where there was a wholesale failure by them to carry out their compliance responsibilities.”

# Gatekeeper Liability in Regulatory Enforcement

## *Recent Finance & Accounting Cases*

### **SEC v. Nicholas Bowerman, No. 1:24-cv-12282 (D. Mass. filed Sept. 5, 2024):**

- Pending enforcement action against former finance director at Pipeline Energy, a subsidiary of CIRCOR International.
- Bowerman allegedly manipulated CIRCOR's internal accounting records by falsifying the financial results of a subsidiary before they were included in the company's consolidated financial statements.
- The SEC charged Bowerman with several fraud-related charges under Section 17 of the Securities Act and Section 10(b) of the Exchange Act.

# Gatekeeper Liability in Regulatory Enforcement

## *Recent Legal & Compliance Cases*

### **In re Ronald Prague, SEC Rel. No 34-95055 (June 7, 2022):**

- Settled administrative proceeding against Synchronoss Technologies and its former general counsel for accounting fraud in improperly recognizing revenue on multiple transactions.
- Prague furthered the fraudulent scheme by misleading external auditors about the nature of the transactions in question.

### **Two Point Capital Management, Inc., and John B. McGowan, Admin. Proc. File No. 3- 21249 (Dec. 5, 2022):**

- Founder, sole shareholder, and CEO of registered investment adviser also served as its CCO and “was the only individual responsible for implementing and developing Two Point’s compliance policies and procedures and Code of Ethics.”
- McGowan was charged in his CCO role for failure to implement adequate compliance policies.

# Gatekeeper Liability in Regulatory Enforcement

## *Finance / Accounting / Legal Takeaways*

### **Finance, Accounting, and Legal functions remain a regular target for enforcement.**

- Finance, Accounting, and Legal employees' access to relevant information and systems, and knowledge of where the “bodies” are buried, often make them integral to regulatory violation schemes.
- However, liability can arise merely from failure to perform one's function with due care.
  - *See SEC v. Vidul Prakash*, 3:23-cv-03300 (N.D. Cal. filed July 3, 2023): SEC charged CFO of View, Inc., with negligently failing to accrue for and disclose over \$20 million in liabilities reflecting projected costs to ship and install replacement smart windows, in violation of Section 17(a)(3).
  - “Despite receiving queries from the SEC and from View's own controller that raised questions and concerns regarding the adequacy of View's disclosed warranty liabilities, Prakash failed to address those questions and concerns and continued to maintain View's warranty liabilities at a level that excluded the Installation Costs that View had decided to incur.”

# Gatekeeper Liability in Regulatory Enforcement

## Recent Technology Cases

- ***SEC v. SolarWinds Corp. & Timothy G. Brown***, No. 1:23-cv-09518 (S.D.N.Y. filed Oct. 30, 2023):
  - Enforcement action in which the SEC alleged that SolarWinds and its chief information security officer violated securities laws by understating cybersecurity risks associated with one of its products and misleading the public about a series of cyberattacks
  - Notably, the SEC alleged that SolarWinds’s cyber security failure amounted to a violation of the Exchange Act’s requirement that issuers “devise and maintain a system of internal accounting controls.” See 15 U.S.C. § 78m(b)(2)(B).
    - The district court dismissed this claim, holding that cybersecurity-related deficiencies are not actionable under SEC rules related to internal accounting and disclosure
  - The court allowed some claims against Brown to proceed, signaling that companies and technology gatekeepers should remain vigilant in responding to cybersecurity incidents and issuing proper disclosures



# Gatekeeper Liability in Regulatory Enforcement

## *Spotlight: Internal Accounting Controls*

**The Solar Winds case is only the most notable in a recent string of SEC enforcement actions expanding the concept of “internal accounting controls” that issuers are required to maintain pursuant to Exchange Act Section 13(b)(2)(B).**

- JPMorgan Chase (SEC Rel. No. 34-79335, Nov, 17, 2016) (referred hires)
- United (SEC Rel. No. 34-79454, Dec. 2, 2016) (maintaining flight for Port Authority official)
- Andeavor (SEC Rel. No. 34-90208, Oct. 15, 2020) (stock buybacks contrary to policy)
- R.R. Donnelley (SEC Rel. No. 34-100365, June 18, 2024) (cybersecurity)

Commissioners Peirce and Uyeda referred to Section 13(b)(2)(B) as the “SEC’s Swiss Army Statute” in November 2023.

# Gatekeeper Liability in Regulatory Enforcement

## Recent Senior Executive Cases

- ***SEC v. Hertz Global Holdings, Inc. and the Hertz Corp.***, SEC Rel. No. 34-10601 (Dec. 31, 2018) & ***SEC v. Mark Frissora***, No. 2-20-cv-10453 (D.N.J. filed Aug. 13, 2020):
  - Settled administrative proceeding and enforcement action against Hertz and its former CEO related to significant misstatements in Hertz’s financial statements.
    - Over a two-year period, Hertz misstated its pre-tax income by approximately \$235 million.
  - The SEC charged then-CEO Mark Frissora with aiding and abetting Hertz’s reporting and books and records violations.
  - The Commission alleged that Frissora pressured members of the Finance and Accounting department to materially misstate financial reports. For example, as Hertz’s financial results fell short of forecasts, Frissora pressured subordinates to “find money.”

# Gatekeeper Liability in Regulatory Enforcement

## *Senior Executive Takeaways*

### **Senior Executives Have Gatekeeper Roles**

- Although businesspeople are often the individuals being overseen by traditional gatekeepers, they still play an important role in achieving compliance at a regulated company. Additionally, when a businessperson becomes sufficiently senior, they are viewed as having particular responsibility, in part by virtue of their supervision of the supervisors.
- **Certifying the Accuracy of Financial Statements & Internal Controls**
  - Sarbanes-Oxley requires public company CEOs and CFOs to personally certify the accuracy and completeness of the company's financial reports and that the company has established and maintained effective internal controls over financial reporting. See SOX Sections 302, 906.
- **Acting as Control Persons**
  - Senior executives can be held liable for violations of the securities laws if they exercised control over the violator. See 15 U.S.C. §§ 77o, 78t.

# Gatekeeper Liability in Regulatory Enforcement

## *Senior Executive Takeaways*

### ***SEC v. Nature's Sunshine Products, Inc., Douglas Faggioli, and Craig D. Huff, No. 2:09-cv-00672 (D. Utah filed July 31, 2009):***

- Faggioli and Huff were CEO and CFO, respectively, of Nature's Sunshine Products when agents of the company's Brazilian subsidiary paid cash bribes to Brazilian customs officials to evade restrictions on the importation of the company's products.
- “During the period 2000 through 2001, Faggioli and Huff, directly or indirectly, as Control Persons, failed to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions were recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements.”

# Gatekeeper Liability in Regulatory Enforcement

## *Recent Board of Directors Cases*

### ***SEC v. Joshua A. Weiss & Grainne M. Coen***, No. 24-cv-06988 (S.D.N.Y. filed Sept. 16, 2024):

- Pending enforcement action against two of Kubient, Inc.'s directors, including the chair of Kubient's Audit Committee.
- Kubient, Inc., an AI company, allegedly misled the public about the capabilities of its AI platform and overstated revenue in advance of its IPO.
- Kubient's CEO allegedly fabricated reports demonstrating that Kubient had performed services that it had not, in fact, performed. In so doing, inflating the company's revenue.
- The directors (Weiss and Coen) allegedly learned about the deceptive conduct but failed to further investigate the fraud or correct the affected financial statements. They also allegedly perpetuated the fraudulent scheme by lying to Kubient's independent auditor and making false statements to the public about the revenue at issue.

# Gatekeeper Liability in Regulatory Enforcement

## Recent Board of Directors Cases

### Beware of red flags.

- ***SEC v. Vasant Raval***, No. 8:10-cv-00101 (D. Neb. filed Mar. 15, 2010):
  - Chairman of the infoUSA Inc. Audit Committee “became aware of red flags concerning certain payments made by Info to [former Chairman and CEO Vinod Gupta] for personal expenses, and concerning certain related party transactions with Gupta’s entities. Raval, however, did not take appropriate action and, although he knew, or was reckless in not knowing, that the red flags had not been addressed, he reviewed and signed Info’s 2004 through 2006 Forms 10-K.”
- ***SEC v. Jerome Krantz, Cary Chasin, and Gary Nadelman***, No. 0:11-cv-60432 (S.D. Fla. filed Feb. 28, 2011):
  - Members of DHB’s Audit and Compensation Committees failed to carry out their responsibilities and instead were willfully blind to red flags signaling accounting fraud, reporting violations, and misappropriation.

# Gatekeeper Liability in Regulatory Enforcement

## *Recent External Auditor Cases*

### ***Scott Marcello***, PCAOB Rel. No. 105-2022-004 (Apr. 5, 2022):

- Settled PCAOB enforcement action against former Vice Chair of Audit for large accounting firm for failing to supervise firm personnel who improperly obtained confidential PCAOB inspection information.
- “This ‘first of its kind’ disciplinary action demonstrates that the PCAOB is committed to sanctioning top-level personnel at the largest firms when they fail to take sufficient supervisory steps aimed at preventing violations by their subordinates,” said PCAOB Chair Erica Y. Williams.

# Gatekeeper Liability in Regulatory Enforcement

## *External Auditor Takeaways*

### **Trend in PCAOB rules, standards, and enforcement is toward increased onus on and liability for gatekeepers.**

- QC 1000 requires designation of particular individuals with regulatory responsibility for the operation of a registered firm's QC system. Individuals are required to carry out their responsibilities with due professional care.
- *See also:*
  - PCAOB Rule 3502 (recently revised to reduce threshold for contributory liability from recklessness to negligence).
  - ***Marc Hogeboom***, PCAOB Rel. No. 105-2024-023 (Apr. 10, 2024): Head of Assurance for large non-U.S. firm sanctioned for failure to respond to indications of potential improper answer sharing by firm personnel and contributing to the firm's inaccurate representations to the PCAOB.



# Gatekeeper Liability in Regulatory Enforcement

## *Recent Outside Counsel Cases*

- ***SEC v. Matthew C. McMurdo, Esq.***, SEC Rel. No. 34-101119 (Sept. 20, 2024):
  - Settled enforcement action against an attorney whose opinion letters for an issuer contained numerous inaccuracies.
  - McMurdo “observed inconsistencies and inaccuracies in various [issuer] disclosure reports that made him feel uncomfortable, yet he continued to issue and sign opinion letters on behalf of” the issuers.
  - Therefore, McMurdo engaged in improper professional conduct in violation of Exchange Act Section 4C(a)(2) and Rule 102(e) by violating New York Rules of Professional Conduct 1.1 (Competence), 1.3(a) (Diligence), and 8.4 (Misconduct).

# Gatekeeper Liability in Regulatory Enforcement

## *Gatekeeper Enforcement Post-Jarkesy*

**In *SEC v. Jarkesy*, 144 S. Ct. 2117 (2024), the Supreme Court limited the SEC’s ability to try cases before in-house administrative law judges.**

- In the wake of *Jarkesy*, the SEC has dismissed a number of pending administrative cases. At the same time, SEC personnel have underscored that *Jarkesy* will not deter it from bringing enforcement actions against gatekeepers.
  - “To my friends on the defense bar, be careful what you wish for, because even if we’re not pursuing our auditor cases in the [administrative] 102(e) context, those cases against gatekeepers are not going away.” Benjamin Hanauer, SEC Supervisory Trial Counsel, September 2024
  - “Uncertainty in the courts does not mean that we’re going to retreat from holding gatekeepers accountable.” Ryan Wolfe, SEC Chief Enforcement Accountant, April 2024

# Gatekeeper Liability in Regulatory Enforcement

## Key Regulatory Enforcement Takeaways

**Gatekeepers may be liable either for failing to perform their function or by participating in the wrongdoing.**

- Gatekeepers may be at the center of a company's response to wrongdoing, which means that the onus is on them not to participate in subsequent wrongdoing such as misleading other gatekeepers or the government.

**Professionals may have particular gatekeeping responsibilities.**

- Lawyers, accountants, and auditors have codes of conduct and professional responsibilities that may not be shared by other employees. Violation of those responsibilities may be a basis for regulatory enforcement.

**Similar considerations can arise from specific assigned regulatory roles, e.g.:**

- BSA/AML Compliance Officers
- Export Control Empowered Officials

# **GATEKEEPER LIABILITY IN PRIVATE LITIGATION**

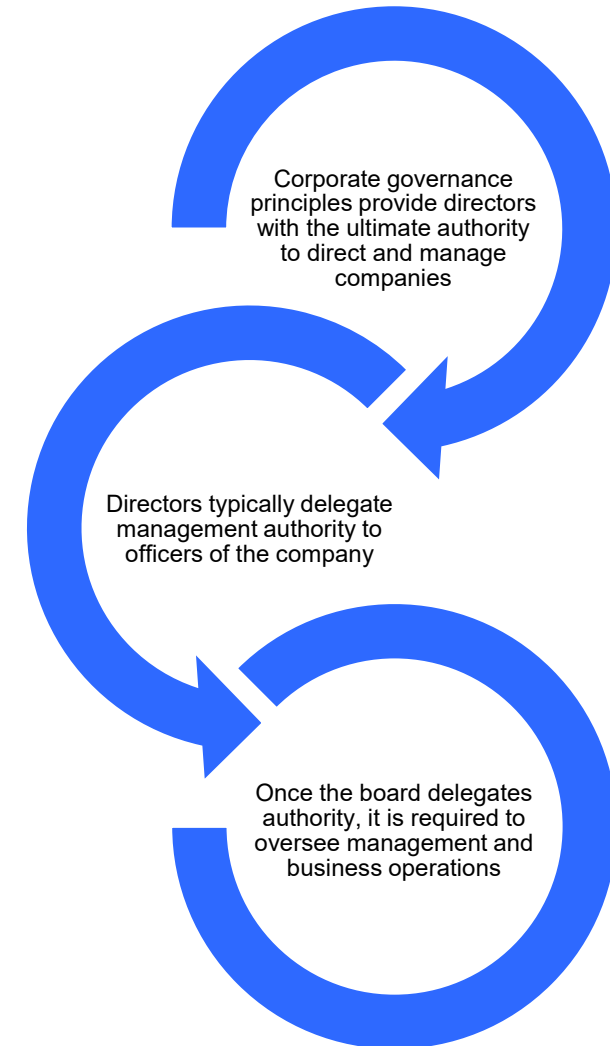
**03**

# Gatekeeper Liability in Private Litigation

## *Directors' Unique Role*

## Directors' Unique Gatekeeping Role

- **As the ultimate corporate decision-makers, directors have a duty to oversee delegations of their authority**
- **Shareholders can bring derivative claims against directors who fail to provide proper oversight**



# Gatekeeper Liability in Private Litigation

## Caremark *Claims*

### Director Liability for Failure to Provide Oversight (*Caremark Claims*)

- To be held liable for the failure to provide proper oversight, a shareholder must show a director (or corporate officer)

(1) “utterly fail[ed] to implement any reporting or information system or controls,” or

(2) “having implemented such a system or controls, consciously fail[ed] to monitor or oversee its operations,” which disabled them “from being informed of risks or problems requiring their attention”

***In re Caremark Int’l Inc. Deriv. Litig.***, 698 A.2d 959, 970 (Del. Ch. 1996)

# Gatekeeper Liability in Private Litigation

## Caremark Claims

### Asserting a *Caremark* Claim Against Directors for Failing to Provide Proper Oversight is Difficult . . .

- *Caremark* claims are “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment”
- Historically, *Caremark* claims have been routinely dismissed at the pleading stage

# Gatekeeper Liability in Private Litigation

## Caremark *Claims*

### Asserting a *Caremark* Claim Against Directors for Failing to Provide Proper Oversight is Difficult, **But Not Impossible**

- In the past few years, a greater number of complaints alleging the failure to provide proper oversight have been allowed to proceed
- These complaints generally allege egregious facts



# Gatekeeper Liability in Private Litigation

## Noteworthy Examples of Caremark Claims

### Recent *Caremark* Claims

- ***Marchand v. Barnhill***, 212 A.3d 805 (Del. 2019)
  - After a listeria outbreak in Blue Bell's manufacturing plants, three people died and Blue Bell recalled all of its products, shut down production, and laid off one-third of its workers
  - A shareholder filed a derivative action alleging *Caremark* claims against Bluebell's directors alleging an "utter failure to attempt to assure a reasonable information and reporting system exists"
  - The Delaware Supreme Court agreed, holding that the shareholder had alleged particularized facts supporting a reasonable inference that the board "made no effort" to implement a board-level system to monitor the safety of the company's only product. The complaint alleged:
    - The board had no committee overseeing food safety
    - The board had no full board-level process to address food safety issues
    - The board had no protocol by which the board was expected to be advised of food safety reports and developments
    - Management was aware of significant food safety issues but failed to report those issues to the board, further suggesting the absence of a food safety reporting system

# Gatekeeper Liability in Private Litigation

## *Noteworthy Examples of Caremark Claims*

## Recent *Caremark* Claims

- *In re Boeing Co. Derivative Litigation*, 2021 WL 4059934 (Del. Ch. Sept. 7, 2021)
  - Shareholders alleged that Boeing's directors failed to oversee safety issues relating to software problems with 737 MAX aircraft that were known to management, namely:
    - No board committee was specifically tasked with overseeing airplane safety, and every committee charter was silent with respect to airplane safety
    - The audit committee focused on financial and production risks, and not on airplane safety risks
    - The enterprise risk visibility process overseen by the audit committee focused on financial and production risks, and did not specifically emphasize airplane safety
    - The board's yearly updates on compliance did not address airplane safety, and airplane safety was not a regular agenda item at board meetings.
    - Management did not report to the board on safety issues, and the board did not have a means of receiving internal reports and complaints about safety, including whistleblower complaints
  - The court found that the plaintiffs pled sufficient facts to support claims that the board failed to establish a reporting system for airplane safety

# Gatekeeper Liability in Private Litigation

## Key Takeaways

### ***Caremark* Takeaways**

- **Directors should identify “mission-critical” or key risks facing the company and delegate responsibility for oversight of these risks to specific board committee**
- **Mission critical risks include legal compliance and other risks (such as cybersecurity risks and employee-welfare risks) that are central to the business**
- **Mission critical risks could also include key areas of risk that may develop in the future**
- **Directors should be active in establishing effective management of key risks as a corporate priority**
- **Directors should set a regular schedule for reporting from management on key risks and be proactive in seeking out additional reports when appropriate**
- **Directors should proactively address “red flags” and create a record of risk monitoring and oversight efforts**

# TAKEAWAYS AND Q&A

04

# Questions?

# THANK YOU!

Please note that this presentation has been prepared for general informational purposes only and is not intended as legal advice.



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